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NAVAL POSTGRADUATE SCHOOL

Monterey, California



THESIS

REVIEW AND EVALUATION OF THE NAVY'S
IMPLEMENTATION OF THE FEDERAL MANAGERS'
FINANCIAL INTEGRITY ACT

by

Matthew D. Culbertson

June 1987

Thesis Advisor:

Joseph G. San Miguel

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T233118

UNCLASSIFIED

SECURITY CLASSIFICATION OF THIS PAGE

REPORT DOCUMENTATION PAGE

UNCLASSIFIED

| | | | | | |
|---|-------|---|---|---|--------------------------------|
| 1a REPORT SECURITY CLASSIFICATION Unclassified | | | 1b RESTRICTIVE MARKINGS | | |
| 2a SECURITY CLASSIFICATION AUTHORITY | | | 3 DISTRIBUTION/AVAILABILITY OF REPORT Approved for public release; distribution is unlimited | | |
| 2b DECLASSIFICATION/DOWNGRADING SCHEDULE | | | 5 MONITORING ORGANIZATION REPORT NUMBER(S) | | |
| 4 PERFORMING ORGANIZATION REPORT NUMBER(S) | | | 5 MONITORING ORGANIZATION REPORT NUMBER(S) | | |
| 6a NAME OF PERFORMING ORGANIZATION Naval Postgraduate School | | 6b OFFICE SYMBOL (if applicable) 54 | | 7a NAME OF MONITORING ORGANIZATION Naval Postgraduate School | |
| 6c ADDRESS (City, State, and ZIP Code) Monterey, California 93943-5000 | | | 7b ADDRESS (City, State, and ZIP Code) Monterey, California 93943-5000 | | |
| 8a NAME OF FUNDING/SPONSORING ORGANIZATION | | 8b OFFICE SYMBOL (if applicable) | | 9 PROCUREMENT INSTRUMENT IDENTIFICATION NUMBER | |
| 8c ADDRESS (City, State, and ZIP Code) | | | 10 SOURCE OF FUNDING NUMBERS | | |
| | | | PROGRAM ELEMENT NO | PROJECT NO | TASK NO |
| | | | WORK UNIT ACCESSION NO | | |
| 11 TITLE (Include Security Classification) REVIEW AND EVALUATION OF THE NAVY'S IMPLEMENTATION OF THE FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT | | | | | |
| 12 PERSONAL AUTHOR(S) Culbertson, Matthew D. | | | | | |
| 13a TYPE OF REPORT Master's Thesis | | 13b TIME COVERED FROM _____ TO _____ | | 14 DATE OF REPORT (Year, Month, Day) 1987 June | |
| | | | | 15 PAGE COUNT 81 | |
| 16 SUPPLEMENTARY NOTATION | | | | | |
| 17 COSATI CODES | | | 18 SUBJECT TERMS (Continue on reverse if necessary and identify by block number) | | |
| FIELD | GROUP | SUB-GROUP | Internal Controls, Financial Management, Federal Managers' Financial Integrity Act, Management Control, Navy Internal Control Program | | |
| | | | | | |
| | | | | | |
| 19 ABSTRACT (Continue on reverse if necessary and identify by block number) | | | | | |
| <p>This thesis provides a review and evaluation of the Navy's implementation of the Federal Managers' Financial Integrity Act. Topics considered include: internal control in the Federal Government; overview of the internal control evaluation system; the Department of the Navy's internal control program including Navy implementation problems; and Navy solutions and shortcomings to the implementation problems. The research consisted of interviews with Naval activities on implementation problems and solutions and a review of relevant General Accounting Office audits and other relevant instructions and studies.</p> <p>The conclusion was reached that the Navy has made fair progress in implementing the Act but further action is required. Recommended actions include</p> | | | | | |
| 20 DISTRIBUTION/AVAILABILITY OF ABSTRACT <input checked="" type="checkbox"/> UNCLASSIFIED/UNLIMITED <input type="checkbox"/> SAME AS RPT <input type="checkbox"/> DTIC USERS | | | 21 ABSTRACT SECURITY CLASSIFICATION Unclassified | | |
| 22a NAME OF RESPONSIBLE INDIVIDUAL Professor Joseph G. San Miguel | | | 22b TELEPHONE (Include Area Code) 408-646-2187 | | 22c OFFICE SYMBOL Code 54Sm |

19. ABSTRACT (continued)

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Review and Evaluation of the Navy's
Implementation of the
Federal Managers' Financial Integrity Act

by

Matthew D. Culbertson
Lieutenant Commander, Supply Corps, United States Navy
B.S., University of South Carolina, 1977

Submitted in partial fulfillment of the
requirements for the degree of

MASTER OF SCIENCE IN MANAGEMENT

from the

NAVAL POSTGRADUATE SCHOOL
June 1987

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1925-6
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I. INTRODUCTION

A. PURPOSE

The Federal Managers' Financial Integrity Act of 1982 (FMFIA) requires department and agency managers to identify internal control and accounting system weaknesses that can lead to fraud, waste and abuse in government operations. The issue of implementing an effective internal control program in the Navy is very important. With increasing public scrutiny over the misuse of government assets, Navy managers will need to become more concerned with obtaining and utilizing resources effectively and efficiently in accomplishing their objectives. One means to achieving these objectives is an effective internal control program. The FMFIA provides an important impetus to restoring public confidence in the management of the government. In its current implementation of the Act, the Navy has made a concerted effort to comply with the Act's spirit and letter, and has made some progress in greater organizational coverage and more effective internal control evaluations. Implementation of an effective internal control program in the Navy to meet the objectives of the FMFIA has not been smooth sailing for the Navy and other federal agencies as they have encountered numerous implementation problems. The purpose of this thesis is to review and evaluate the Navy's

Progress in implementing the FMFIA including discussion of past implementation problems and to identify areas for improvement that managers can use to help them with the internal control process.

B. BACKGROUND

The Budget and Accounting Act of 1950 required the head of each department and agency to establish and maintain adequate systems of internal control.

With growing concern over numerous publicized cases of government mismanagement of resources, Congress amended the Budget and Accounting Act via the FMFIA to require ongoing evaluations and reports on the adequacy of the system of internal controls. The Act further requires federal managers to correct the weaknesses and report annually to the President and the Congress on their programs. The FMFIA also required the Office of Management and Budget (OMB) to consult with the Comptroller General of the United States to establish guidelines for these evaluations and reports. OMB revised the already established government policy on internal control and assigned management the responsibility of establishing, maintaining, reviewing and improving internal control systems in each agency.

Unfortunately, the Navy has experienced implementation difficulties with the FMFIA. Some of the implementation problems encountered by the Navy include initial lack of

guidance from the headquarters level, no training for line managers on how to perform required reviews, significant resistance from line managers to complete required reviews and the significant amount of time and paperwork burden associated with the entire management control review process.

C. SCOPE AND METHODOLOGY

The objective of this thesis is to examine and evaluate the Department of the Navy's progress in implementing the Act. The history and evolution of internal control in the Federal Government and an overview of the current internal control evaluation system will be reviewed.

This thesis then presents the research effort by first presenting a history of the Navy's internal control program, a review of the Navy's financial management structure and accounting systems weaknesses. Then the problems experienced by the Navy in implementing an effective internal control program are discussed. This is followed by examining the solutions to the implementation problems as well as the shortcomings of these solutions.

Finally, the conclusion is reached that there are ways to improve the process, such as improving direction and coordination in the Act's implementation, emphasizing alternatives to internal control reviews, focusing efforts on high risk areas, improving management training and using a checklist approach to completing the required reviews.

The research consisted of telephone interviews to solicit any innovative ideas to improve implementation of the Act. In addition, a detailed search and evaluation was made of the literature in the area of internal control systems and the GAO audits of the Navy's progress in implementation of the Act.

D. ORGANIZATION OF THESIS CHAPTERS

Chapter II provides a discussion on the background of the Federal Government's internal control system. This includes a discussion of the Budget and Accounting Act of 1950, OMB Circular A-123, the FMFIA, and the GAO standards for internal controls in the Federal Government.

Chapter III examines the internal control evaluation system. This chapter covers the DOD internal control evaluation process, including performing vulnerability assessments and management control reviews.

Chapter IV details the history of the Navy's Internal Control Program, the Navy's financial management structure and accounting systems weaknesses, and covers the implementation problems the Navy has experienced in implementing their internal control program.

Chapter V details the Navy's implementation problems solutions and the shortcomings of those solutions.

Chapter VI provides a summary along with some conclusions about and recommendations for further implementation of the FMFIA.

II. INTERNAL CONTROL IN THE FEDERAL GOVERNMENT

A. BUDGET AND ACCOUNTING ACT OF 1950

The Budget and Accounting Act was passed in 1950 and required that each agency head establish and maintain systems of accounting and internal control. The passage of the Act produced high expectations that these systems of accounting and internal control would help reduce or prevent fraud, waste, abuse and mismanagement in Federal Government operations. Unfortunately, development of effective systems has been slow and numerous situations continue to appear in the news headlines which show lack of fiscal responsibility, such as instances of fraud, waste and abuse continue to occur at unacceptable levels.

B. OFFICE OF MANAGEMENT AND BUDGET CIRCULAR A-123

One reason given for the ineffectiveness of the Budget and Accounting Act was its lack of enforcement. Although the Act was understood as the current standards of internal standards of internal control, it did not provide specific guidance on internal control systems or require mandatory reports on the quality of those systems.

To give the Act more teeth, OMB issued Circular A-123 in October 1981 as an early effort to improve controls. The Circular required the head of each department and agency to develop and maintain adequate systems of internal control.

Unlike the 1950 Act, however, it defined requirements and responsibilities in order to transform the 1950 Act's expectations and enforcement into reality.

The purpose of A-123 is to prescribe policies and procedures to be followed by executive departments and agencies in establishing, maintaining, evaluating, improving, and reporting on internal controls in their program and administrative activities (ref. 1:p.1).

Congress also saw the need for effective internal management in the Federal Government. The pressure for Congress to act to force improvement in the government agencies' internal management was fueled by the numerous headlines of fraud, waste and abuse in federal activities and programs, eroding public confidence, and the government's inability to operate effectively. Continuing concern over the poor condition of government internal control and accounting systems led the Congress to pass the Federal Managers' Financial Integrity Act of 1982 (P.L. 97-255).

C. FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT OF 1982

This Act requires that agency heads annually report to the President and the Congress as to whether their internal accounting and administrative control systems comply with the Comptroller General's internal control standards and provide reasonable assurance that:

- obligations and costs are in compliance with applicable law;

- funds, property and other assets are safeguarded;and
- revenues and expenditures are properly recorded and accounted for (ref. 2:p.2).

The Act requires that each agency evaluate its internal control system in accordance with guidelines prescribed by OMB and report annually any material internal control weaknesses together with plans for correction. The annual report must also indicate whether or not the agency's accounting system conforms to the Comptroller General's accounting requirements.

The Act directed that the evaluation and reporting requirements be implemented in two steps. The first step was the preparation of guidelines for the evaluation of internal and administrative controls by OMB in consultation with the Comptroller General by December 31,1982. The second step required commencement of annual reporting by the agencies by December 31, 1983.

D. STANDARDS FOR INTERNAL CONTROLS IN THE FEDERAL GOVERNMENT

To satisfy the first step, it was necessary to define what was meant by internal control. The American Institute of Certified Public Accountants (AICPA) has made a distinction between internal accounting controls and administrative controls. Administrative controls are concerned with the decision processes leading to management's authorization of transactions. This authorization is the starting point for establishing

internal accounting control of transactions. Internal accounting controls are concerned with safeguarding of assets and reliability of financial records. Given the AICPA definitions of administrative and internal accounting controls, the Federal Government needed to develop standards for internal controls. OMB requested GAO to develop these standards. GAO responded by publishing STANDARDS FOR INTERNAL CONTROLS IN THE FEDERAL GOVERNMENT in 1983. This document, which has come to be known as the "green book" was derived from the professional standards established by the AICPA and includes the following concept of internal controls which is useful in understanding and applying the internal control standards: "The plan of organization and methods and procedures adopted by management to ensure that resource use is consistent with laws, regulations and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data are obtained, maintained, and fairly disclosed in reports." (ref. 3:p.1)

What is an internal control standard? GAO defines it as: "the minimum level of quality acceptable for internal control systems in operation and constitute the criteria against which systems are to be evaluated." (ref.3:p.2) The definition adds that these standards apply to all functional areas, not the financial or accounting areas. Each area has some inherent internal controls in the form of

instructions mission and performance requirements and program objectives.

The "green book" breaks the standards for internal control into three areas: general standards, specific standards, and the audit resolution standard.

1. General Standards of Internal Control

GAO lists five general standards of internal control which apply to all aspects of internal controls.

a. Reasonable Assurance

"Internal control systems are to provide reasonable assurance that the objectives of the systems will be accomplished."(ref.3:p.4) The term "reasonable assurance" is inherently subjective, difficult to define and requires judgment to be exercised. The concept of reasonable assurance recognizes that internal controls must be cost-beneficial. That is, the cost of internal control should not exceed the benefit derived. A cost here refers to the financial measure of resources consumed in accomplishing a specified purpose. The benefit derived from a control refers to the reduction in risk from failing to achieve the objective of the control. Because the benefit is often not precisely quantifiable, it is more difficult to define and determine, and decisions must depend on estimates and judgments by management. To increase the amount of control in an area usually will result in an increase in cost. Therefore, the judgment required to be performed with each

control is whether the cost of the control exceeds the benefits derived.

b. Supportive Attitude

"Managers and employees are to maintain and demonstrate a positive and supportive attitude toward internal controls at all times." (ref.3:p.4) Line management commitment to achieving effective internal controls is vital to the success of achieving the intent of this standard. This standard requires agency managers and employees to be attentive to internal control matters and to take steps to promote the effectiveness of the controls. The bottom line here is that overall leadership is critical to maintaining a positive and supportive attitude toward internal controls. This is accomplished through training, motivating employees and encouraging management improvement suggestions.

c. Competent Personnel

"Managers and employees are to have personal and professional integrity and are to maintain a level of competence that allows them to accomplish their assigned duties, as well as understand the importance of developing and implementing good internal controls." (ref. 3:p.5) Managers and their staffs are required to maintain and demonstrate their personal and professional integrity, a skill level necessary to ensure effective performance and a sufficient understanding of internal controls to effectively discharge their responsibilities. Professional integrity

can be promoted or strengthened through an operative code of conduct. In addition, staffing decisions should include verification of minimum education and skill requirements. In the Federal Government this is a severe limitation. Therefore, training programs are required. Performance appraisals should also include an assessment of the manager's implementation and maintenance of effective internal controls. Managers who possess a good understanding of internal controls are vital to effective control systems, and these managers should be used in formal and on-the-job training programs.

d. Control Objectives

"Internal Control objectives are to be identified or developed for each agency activity and are to be logical, applicable, and reasonably complete." (ref.3:p.6) The purpose of this standard is that the control objectives are tailored to the agency for each of its operations. Usually, all operations of an agency are grouped into cycles that are compatible with the agency's division of responsibilities. Some agencies collect cash, others do not; some pay out cash; some are more administrative in nature; and some are more program and less financially oriented. Examples of cycles include financial, administrative, agency management and program (operational) cycles. These cycles interact and controls over their interaction must be established. To comply with this

standard, an agency must identify and analyze each cycle to determine the internal control objectives. These objectives can then be used to evaluate the agency's internal controls.

e. Control Techniques

"Internal control techniques are to be effective and efficient in accomplishing their internal control objectives." (ref.3:p.7) The final general standard requires that the techniques of control are effective and efficient. Internal control techniques are the mechanisms by which control objectives are achieved. These techniques are policies, procedures, organizational plans and physical layouts. Control techniques must insure that the objective is met with a high degree of assurance within cost limitations. All control techniques should be reviewed periodically and evaluated as to their effectiveness and efficiency and be modified as required. Effectiveness means that the techniques fulfill their intended purpose. Efficiency means that the techniques are designed to provide maximum benefit with minimum effort. For example, adding more personnel to the internal control process may improve the effectiveness of techniques but not necessarily the efficiency.

2. Specific Standards of Internal Control

A number of techniques are essential to providing the greatest assurance that the internal control objectives are achieved. There are six critical specific standards.

a. Documentation

"Internal control systems and all transactions and other significant events are to be clearly documented, and the documentation is to be readily available for examination." (ref.3:p.8) Basically, this standard requires that agencies document their internal control objectives, techniques and accountability systems and also document all pertinent aspects of transactions and other significant events of an agency. This documentation can be in a variety of forms, including policy manuals, management directives or flowcharts of transactions. Complying with the documentation standard requires that the documentation of internal control systems and transactions and other significant events be purposeful and useful to managers in controlling their operations and also provides auditors with a guide for their review.

b. Recording of Transactions and Events

"Transactions and other significant events are to be promptly recorded and properly classified." (ref.3:p.9) This standard applies to the entire life cycle of a transaction and includes initiation and authorization, all aspects of the transaction while in process and its final classification in summary records. This standard also provides management with the information it needs to control operations and provides summary records from which reports are prepared and for internal review and

audits. Failure to adhere to this standard can result in a loss of information if transactions are not recorded or are misclassified. Also, if the information is untimely the agency's reports can be erroneous.

c. Execution of Transactions and Events

"Transactions and other significant events are to be authorized and executed only by persons acting within the scope of their authority." (ref.3:p.9) The purpose of this standard is to assure that only valid transactions and other events are entered into. Organizations must have clear lines of authority for certain decisions such as cash payments. Independent evidence should be maintained so that proper authorizations are issued and so that the transactions conform with the terms of the authorizations. Authorization must be clearly understood by all persons concerned and specific conditions of authorization must be clear to ensure compliance with this standard.

d. Separation of Duties

"Key duties and responsibilities in authorizing, processing, recording, and reviewing transactions should be separated among individuals." (ref.3:p.10) No one individual should control all key aspects of a transaction or event. The primary factor for deciding when to separate duties is if the performance of duties by one person would allow that person to commit fraud or abuse the system. Duties and responsibilities should be

assigned to a number of individuals to ensure effective checks and balances exist. One major area to watch in this area is collusion, because collusion can reduce or destroy the effectiveness of this standard. Unfortunately, collusion is very hard to discover since it involves two or more individuals.

e. Supervision

"Qualified and continuous supervision is to be provided to ensure that internal control objectives are achieved." (ref.3:p.10) This requires supervisors to continuously monitor the work of their employees and ensure they receive proper training and direction. The assignment, review and approval of employees' work includes communicating the duties and responsibilities clearly, periodic review of performance and approval of work at critical points to ensure timely completion. This standard ties together internal controls and can prevent weaknesses such as collusion from occurring. Supervision is a subset of operational control and is generally concerned with the day to day operations of the organization. Mautz and White say supervision is designed to provide reasonable assurance that employees utilize and conserve the activity's resources and do not undertake actions detrimental to the accomplishment of stated objectives (ref.4:p.15). The process involves managers who get things done by working with others instead of continuously monitoring personnel actions.

f. Access to and Accountability for Resources

" Access to resources and records is to be limited to authorized individuals, and accountability for the custody and use of resources is to be assigned and maintained. Periodic comparison shall be made of the resources with the recorded accountability to determine whether the two agree. The frequency of the comparison shall be a function of the vulnerability of the asset." (ref.3:p.11) The basic concept behind this standard is to restrict access to resources. This will help reduce the risk of fraud, waste or abuse of assets. Some assets, (e.g., cash and pilferable material) are more vulnerable to fraud, waste or abuse than others. This is because of factors such as cost, portability, exchangeability, and the perceived risk of loss or improper use of the resources. Each agency must evaluate its resources and establish control commensurate with these factors that provide reasonable assurance that these resources are safeguarded.

3. Audit Resolution Standard

a. Prompt resolution of audit findings

"Managers are to promptly evaluate findings and recommendations reported by auditors, determine proper actions in response to audit findings and recommendations, and complete, within established timeframes, all actions that correct or otherwise resolve the matters brought to management's attention." (ref.3:p.12)

The process of resolving audit findings begins when the audit results are presented to management and is completed when actions have been taken to correct the identified deficiencies, produce improvements or demonstrate the audit findings are either invalid or do not warrant management action.

E. CONCLUSION

The implementation of the Federal Managers' Financial Integrity Act, OMB Circular A-123 and the GAO Standards for Internal Controls in the Federal Government has been progressing, although not as quickly as was expected. However, the requirement for implementation and evaluation of these controls is real.

The standards for internal control must be understood by the personnel implementing and evaluating these systems. Nevertheless, these are broad guidelines which management must tailor to meet its own specific organization.

Based on our discussion of the standards of internal in the Federal Government, we will next discuss the system of internal control evaluation the Navy is using to implement the Federal Managers' Financial Integrity Act of 1982 and to comply with the requirements of the Act.

III.OVERVIEW OF THE INTERNAL CONTROL EVALUATION SYSTEM

A. INTRODUCTION

Once Congress passed the Federal Managers' Financial Integrity Act of 1982, it became a requirement for each agency to conduct evaluations of their systems of internal control. OMB developed and revised Circular A-123 to issue guidelines for the evaluation of internal controls. These guidelines have been expanded to include not only accounting controls but also administrative controls.

Accounting controls safeguard assets and assure reliability of the financial records. Accounting controls in one form or another are also employed in other nonfinancial functions (e.g., supply, personnel and property management). Administrative controls provide the organizational structure, policies and procedures through which goals and missions are achieved and coordination is maintained. They are designed to assure adherence to applicable regulations and policies. The Department of Defense (DOD) and the Department of the Navy have used the OMB guidance in developing the system currently used to evaluate internal controls in their agencies.

The entire internal control evaluation process must be understood before one can do evaluations and analyze the results. An eight element internal management control

program must be developed by each DOD component in accordance with DOD Directive 5010.38A (ref.5:p.4). The eight elements are:

1. Organizing the internal management control process
2. Segmenting the components into assessable units
3. Conducting vulnerability assessments on those units
4. Developing plans for subsequent action
5. Conducting internal management control reviews or other appropriate management actions
6. Scheduling and taking corrective action
7. Providing for quality control
8. Preparing reports.

This chapter will focus on this process.

B. ORGANIZING THE PROCESS

One of the most critical aspects of the entire internal control process is organizing the evaluation process. Organizing the internal management control process includes assigning responsibilities and providing personnel for planning, directing, and controlling the program; developing internal reporting and tracking capabilities; maintaining documentation; and scheduling evaluations. This organization effort provides the framework that ensures that evaluation improvement and reporting on internal controls is conducted efficiently and effectively.

1. Assigning Responsibilities

The head of the agency is required to submit a statement on the status of the agency's internal controls. However, the preparation of this statement must be delegated down to senior agency officials to ensure that the process of evaluating and reporting on internal controls is in accordance with promulgated guidelines. These senior officials are charged with the responsibility to provide the agency head with written assurances that the program was carried out in an efficient and effective manner.

The assignment of responsibilities should include one senior official to oversee the entire process. This senior official oversees the organizational units and these in turn oversee the heads of individual activities. This process should be organized down to the lowest level of responsibility that is feasible for the efficient operation of the process.

In addition, the Inspector General, internal audit or internal review personnel can be of great help in the organizing process to reduce or prevent duplication of effort.

2. Providing Personnel for the Program

It is essential that a sufficient level of staff support and resources be committed to the process for planning, directing, and controlling. It is highly likely that most of these personnel will have little or no

experience in evaluating internal controls. Therefore, it is essential that, if the process is to be successful, some specific measures are considered such as orientation and training, supervision, technical assistance, monitoring to assure the reviews are performed adequately, and individual appraisal of their performance. Personnel involved in the process should be advised that this will be a factor in their overall performance evaluation.

3. Developing Internal Reporting and Tracking Capabilities

An internal reporting and tracking system must be established to ensure that the evaluation process is performed in a timely manner. The system at a minimum should include reporting and tracking of vulnerability assessments, internal management control reviews and, most importantly, corrective actions to be taken on a timely basis. The system should also be able to provide information to support preparation of the agency's required annual statement and the gathering of information on actions necessary to improve internal controls.

4. Maintaining Documentation

Adequate documentation must be maintained. All documentation connected with the process of conducting vulnerability assessments, internal management control reviews and follow-up action should be kept to provide a record on what was done and who performed the duties. This

information will also be valuable for reviewing the validity of conclusions reached, evaluation of performance of individuals performing the reviews and an audit trail for future assessments.

5. Scheduling Evaluations

The scheduling of evaluations is driven by the Circular A-123 requirements. The process should be scheduled to insure that all reviews are completed in time to support the preparation of the agency's annual statement. In completing the requirement, items such as the cyclical nature of operations, availability of personnel and resource availability should be taken into account.

C. SEGMENTING THE AGENCY

DOD guidance requires that inventories of assessable units shall be established by segmenting the component into organizational, functional, programmatic, or other appropriate subdivisions suitable for evaluating systems of internal management controls, and identifying program and administrative activities of appropriate nature and size to facilitate a meaningful assessment. The resulting listing of assessable units shall be reviewed annually for changes.

In developing the listing of assessable units, reference should be made to sources of information such as organization charts, procedure manuals, the agency's budget, and program management information systems.

Two important factors should be considered when segmenting the agency. First, the segmentation should include the lowest level of responsibility feasible. Second, segmentation of the agency must provide for the systematic evaluation and reporting of internal control systems.

D. CONDUCTING VULNERABILITY ASSESSMENTS

A vulnerability assessment is a review of the susceptibility of all the programs listed in the segmentation process to the occurrence of waste, loss, unauthorized use or misappropriation. The vulnerability assessments do not identify or evaluate the effectiveness of internal controls; they only establish the potential for loss.

Each agency conducts its own vulnerability assessments. They are performed by all levels of management including the lowest possible responsible level as determined by the segmentation process.

The vulnerability assessment consists of three steps: (1) analysis of the general control environment, (2) analysis of inherent risk, and (3) preliminary evaluation of safeguards. Completion of these three steps is then summarized, allowing the assessor to make an overall assessment of the units. The three steps of a vulnerability assessment will be covered below.

1. Analysis of the General Control Environment

The environment of an activity has a major influence on the vulnerability of a program. There are several factors which influence the environment, including:

- Management Attitude- Management recognition of the importance of and commitment to the establishment and maintenance of a strong system of internal control as communicated to employees through actions and words.
- Organizational Structure- The identification of organizational units to perform the necessary functions and the establishment of appropriate reporting relationships.
- Personnel- The competence and integrity of the organization's personnel.
- Delegation and Communication of Authority and Responsibility- Appropriate delegation or limitation of authority in a manner that provides assurance that responsibilities are effectively discharged.
- Policies and Procedures-The definition, documentation and dissemination of information to all employees as to how the organization is intended to perform in various situations.
- Budgeting and Reporting Practices- The specification and communication of organizational goals and the extent of their accomplishment.
- Organizational Checks and Balances- The establishment of an appropriate level of financial and other management controls and internal auditing.
- Automated Data Processing (ADP) Consideration- When utilized, an awareness of the strengths and exposures inherent in a system that uses ADP and the existence of appropriate controls.

The analysis of the general control environment should be performed throughout the agency. It is the first step in the vulnerability assessment process. The analysis can be performed either as a whole or individually for each

component. It should be performed by determining whether or not the characteristics of a strong control environment exists by reviewing policies and procedures, interviewing appropriate management personnel, observing daily practices and by gaining a familiarity with the operations.

2. Analysis of Inherent Risk

The second step in the vulnerability assessment process is to perform an analysis of the inherent potential risk for waste, loss, unauthorized use or misappropriation due to the nature of the activity. This assessment is performed to determine those programs with higher risk as those programs generally require more control. Some factors to be considered in performing this analysis are:

- Purpose and characteristics of the program
- Budget level allocated to the program
- Impact of the program outside the agency
- Age and expected life of the program
- The degree of centralization of the program
- Special concerns of the program
- Prior reviews of the program
- Management responsiveness within the program

3. Preliminary Evaluation of Safeguards

The third step in the vulnerability assessment process is the making of a preliminary evaluation by the reviewer on the existence and adequacy of internal controls over the programs. An important consideration is whether

adequate controls are in place to minimize or prevent waste, loss unauthorized use, or misappropriation. This is not an in-depth review of internal controls, but an assessment by the reviewer of the existence and functioning of current controls.

4. Summarizing the Results of the Vulnerability Assessments

After completing the three steps of the vulnerability assessment process, the reviewer can summarize the results and make an overall assessment of the adherence of the program's internal control system to the prescribed standards and the vulnerability of the program to waste, loss, unauthorized use, or misappropriation. This information allows management to develop a plan for conducting the internal control review process.

E. CONDUCTING INTERNAL MANAGEMENT CONTROL REVIEWS

Once the vulnerability assessments have been completed and summarized, plans and schedules for internal management control reviews or other actions shall be developed based on a ranking of the assessable units' vulnerability.

An internal management control review is a detailed examination of an assessable unit to ensure internal controls exist, are in place, documented and functioning as intended. These in-depth reviews should identify weak, non-existent or excessive controls and initiate actions necessary to correct them.

Internal management control reviews shall include the following six steps:

1. Identification of event cycles
2. Analysis of the general control environment
3. Documentation of the event cycles
4. Evaluation of internal controls within the event cycles
5. Testing the internal controls
6. Reporting the results.

1. Identification of Event Cycles

The first step of this process breaks down each program into their respective event cycles. An event cycle is basically a series of related steps within a program that are held together by significant beginning and end points. Generally accepted auditing standards usually segment event cycles into the following categories: sales and collections, acquisition and payment, payroll and personnel, inventory and warehousing and capital acquisition and repayment. Most programs have many event cycles and each event cycle represents an area that should be examined for internal controls. An example of an event cycle for administration would be a payroll department. The cycle begins with proper authorization of employment, pay computed using only valid time cards, proper withholding of taxes, segregation of duties for personnel processing checks and those distributing them. Another example of an event cycle within an activity publishing directives would include gathering

information, writing a draft, transcribing editing circulating for comments, revising, transcribing in final format, publishing, distributing and updating. Once all the events for a particular program are identified, a determination is made as to their vulnerability to risk. The source of information for this is the results of the vulnerability assessments. The judgment of the person performing the review can also be used. It is important to maintain all documentation relating to this process to provide future reviewers with an audit trail.

2. Review of the General Control Environment

The environment in which the event cycle operates has a major impact on the effectiveness of internal controls. An important part of the internal management control review is an evaluation of the general control environment listed earlier. Analysis of the general control environment performed for the vulnerability assessment can be used for this process but should be updated or modified as required.

3. Documentation of the Event Cycles

The reviewer of an event cycle must thoroughly understand each part of the event cycle. This understanding is accomplished through completely documenting the cycle. This is particularly important when the person preparing the documentation is not the reviewer. The documentation can be in the form of a narrative description or a flowchart with a

narrative description. Documenting the event cycle is accomplished through reviewing past documentation and interviewing personnel involved in the cycle. The documentation should include such things as procedures followed, interviewing personnel performing the procedures and examining the forms and records developed and maintained. Additionally, the reviewer should examine the documentation with personnel involved in the cycle to ensure it accurately reflects the cycle correctly. Also a small number of transactions may be traced through the cycle. Both of these procedures will ensure the documentation and the understanding of the event cycle are accurate.

4. Evaluation of Internal Management Controls

The fourth step in the internal management control process is to evaluate the event cycle by using the documentation. This evaluation should help the reviewer decide if the internal control system is sufficient to provide reasonable assurance against waste, loss, unauthorized use or misappropriation. This evaluation can also determine whether the internal control system meets the requirements of the Federal Managers' Financial Integrity Act and OMB Circular A-123.

The manner in which this is done is to first ascertain the control objectives for the event cycle. If the control objectives are achieved, the potential for the occurrence of waste, loss, unauthorized use or

misappropriation is significantly decreased. Next, the control objectives for an event cycle should be written. This documentation should be reviewed to determine whether the list of objectives for each cycle is complete, logical, and relevant to the event cycle. If the control objectives are not adequately documented, such documentation should be developed and maintained as part of the overall documentation of internal controls. Third, the relationship between this, the prior task, and the inherent risks in an event cycle cannot be overemphasized. Control objectives are established because a risk of loss exists; internal management control techniques are implemented to prevent the specific loss from occurring.

Another important area during this step is to identify whether there are any internal control techniques that are excessive, thereby creating inefficiencies and unnecessary costs.

The final results of this process should identify those internal controls which require testing, the absence of controls that should be corrected, control objectives for which control techniques are not adequate and system corrections that must be made and control techniques that are unnecessary and can be eliminated.

5. Testing of Internal Controls

This is the final step in the review process and is used to evaluate if the controls are functioning as

required. This step is similar to an auditor's compliance test. It may be done by selecting a sample of transactions and reviewing the documentation for those transactions to determine compliance with the related internal control. In addition, observing the controls functioning and interviewing personnel involved can be extremely useful. If control techniques are not functioning properly, the reviewer should evaluate if there is a compensating control. The reviewer should note any other techniques which might also compensate for the control in question. The review should provide documentation for any control weaknesses that were uncovered and possible corrective actions for the weaknesses.

6. Reporting the Results of Internal Management Control Reviews

After completing the internal management control reviews, the results are summarized and reported on. Two types of reports are prepared. The first report provides management of the program information concerning the internal control weaknesses within the system and possible corrections. The first report includes material weaknesses in internal accounting and administrative controls and a schedule for their correction. Also, material weaknesses identified and corrected during the year are included in the first report as accomplishments. The first report is basically an internal document to be used by the individual

command to correct any identified weaknesses. Any recommendations to improve the efficiency and effectiveness of the program should be included. The second report contains a listing identifying material weaknesses in internal accounting and administrative control of significance to the President and the Congress, and gives the agency head the required information necessary to support the agency head's statement. The second report must be made available to the public unless there is an area of the report that is judged to be classified.

F. SCHEDULING AND TAKING CORRECTIVE ACTIONS

DOD Directive 5010.38A requires that a formal follow-up system be established to record and track internal management control deficiencies from any source, schedule corrective actions with completion dates, and provide assistance for the development of plans for implementation of the corrections. The recommended corrective actions of the internal control reviews should be reviewed for possible implementation on a timely basis by the functional area managers. Although no specific penalties are levied for not taking corrective actions, the administrative controls of an activity, if properly functioning, generally have an effect on employee awareness of individual responsibility and provide some sort of assurance that the failure to perform assigned procedures will result in appropriate disciplinary action.

G. QUALITY CONTROL

OPNAVINST 5200.25A (ref.6:p.4) requires that quality control shall be exercised at all levels of command to ensure that the objectives of this program are achieved. Specifically, Navy activities are required to:

1. Ensure internal control training is provided
2. Vulnerability assessments and management control reviews are performed adequately
3. Required reports are prepared accurately and submitted on time
4. Establish a formal follow-up system for monitoring actions to significant and/or systemic weaknesses
5. Establish a system of testing corrective actions to significant and/or systemic weaknesses.

H. CONCLUSION

The process of evaluating internal control systems has been explained in this chapter. Personnel who have received training in internal management control reviews should be able to implement this system. However, the Navy has not been completely successful in implementing this process. The implementation problems encountered by the Navy and the solutions the Navy has come up with to solve these problems will be covered in the next chapters.

IV. INTERNAL CONTROL PROGRAM IN THE DEPARTMENT OF THE NAVY

A. HISTORY OF THE NAVY'S INTERNAL CONTROL PROGRAM

Once the OMB Circular A-123 and DOD guidelines were issued, it was up to the DON to implement an internal control program of their own to satisfy the requirements of the FMFIA.

The Navy's first internal control instruction, SECNAVINST 5200.35, Internal Control in the Department of the Navy, was issued on 29 July 1983. This instruction incorporated the original versions of Circular A-123 and DOD guidance, as well as the FMFIA within DON. The instruction also established the Navy's own program to develop, maintain, review and improve internal control systems to ensure resources are efficiently and effectively managed. In addition, procedures for vulnerability assessments and management control reviews were provided.

The initial responsibility for implementing the program was assigned to the Office of the Assistant Secretary of the Navy for Financial Management (ASN (FM)). One problem with this first instruction was that there was no central focal point for the Chief of Naval Operations' (CNO) office to coordinate subordinate commands inputs. This led to some confusion by Naval activities on exactly how to implement the program at the local level because of no

detailed guidance from the CNO level. In fact, it was not until almost two years later in 1985, at the insistence of the ASN(FM), that the CNO established an office and assigned responsibility for the Navy's internal control program. The role of the CNO's office is explained below.

The SECNAVINST was updated and reissued on 17 May 1985. This revision provided updated fundamental policy guidance and the basic management philosophy of the DON Internal Control Program.

The CNO and the ASN (FM) have different roles with regard to the program. The role of the CNO's office is detailed in OPNAVINST 5200.25A (ref.6:p.5). This instruction was issued 6 January 1986 and assigns responsibility for the Navy's Internal Control Program to the Assistant Vice Chief of Naval Operations (AVCNO) (OP-09B). The AVCNO provides the ASN (FM) with reports and statements required to satisfy the requirements of the FMFIA. The AVCNO is also responsible for promulgating field guidance, developing procedures, establishing reporting requirements, maintaining an assessable unit inventory, monitoring compliance, directing management control reviews, following up on specific weaknesses assigning responsibility for correction of Navy-wide specific, significant and systemic weaknesses, evaluating corrective actions and coordinating all training requirements relating to the internal control program.

The ASN (FM) role, under the Office of the Comptroller of the Navy (NAVCOMPT), is really twofold. First, NAVCOMPT is responsible for the maintenance of their internal control policy instruction on internal control and preparation of NAVCOMPT reports based on input from NAVCOMPT components on the status of the Navy's accounting systems internal controls. More importantly, NAVCOMPT is responsible for writing the Secretary of the Navy's annual compliance statement to the Secretary of Defense by consolidating all upper echelon DON commands such as CNO, Commandant of the Marine Corps and all the Secretariat level offices' annual compliance statements. In preparing the Secretary of the Navy's annual statement, NAVCOMPT extracts all material weaknesses that have Navy-wide application from the individual compliance statements they receive.

B. FINANCIAL ORGANIZATION STRUCTURE OF THE NAVY

DON is a large decentralized organization that accomplishes its mission through the use of a chain of command.

The financial management organization structure within DON has at its head the Assistant Secretary of the Navy for Financial Management (ASN (FM)). The ASN (FM) is responsible for all matters related to the financial management of the DON including budgeting, accounting, disbursing, financing, progress and statistical reporting and auditing. Hence, the

ASN (FM) is the Navy's chief of accounting information systems.

The DON has fourteen major accounting systems that meet the GAO definition of adequate accounting systems. Currently, only one of these systems is in compliance with the DOD Accounting Manual procedures. For example, the Navy's pay and disbursing system (JUMPS) was disapproved by GAO because there were too many errors in the system.

The Navy recognizes that there are major deficiencies in its accounting systems. However, the Navy does have a plan to bring all its accounting systems into substantial compliance with prescribed OMB and Comptroller General principles and standards. This plan is called the DON Strategic Financial Management Master Plan and details the systems, deficiencies and corrective actions.

Some of the major deficiencies identified in the Navy's accounting systems through the management control review process include:

1. Data inaccuracy and incompleteness
2. Information does not meet user needs
3. System is not under full general ledger control
4. Systems do not have adequate internal controls
5. Systems are inefficient, labor intensive and costly
6. Systems do not have adequate audit trails
7. There is no uniform chart of accounts

Each of these deficiencies cause Navy managers problems in trying to analyze their operations and deciding how to control, conserve, protect and use their resources.

The FMFIA has made the Navy focus on getting their accounting systems in order since each accounting system must be reviewed and identified deficiencies corrected. One of the major reasons the Navy felt that they needed to get their accounting systems in order are the possible consequences of reporting the accounting systems as deficient. The possible consequences or penalties of reporting deficiencies are the budget implications and strong managerial leverage that can be applied. There have been recent efforts to reduce the Navy's budget because of internal control weaknesses.

C. EFFECT OF THE FEDERAL MANAGER'S FINANCIAL INTEGRITY ACT

The major effect of the FMFIA on the DON was to provide the Navy with a significant impetus to improve management control and accountability by focusing attention on system problems. To this end the FMFIA has shown some success and the Navy has demonstrated a commitment to strengthen its systems.

However, the initial Navy reaction to the FMFIA and the internal control program was negative. There was significant resistance by management when tasked to perform vulnerability assessments and management control reviews. A number of managers felt that the program was requiring them

to do what auditors did, in that managers were in effect auditing themselves. This negative attitude toward the program by senior line managers was and still is a major stumbling block to effective implementation of the program.

The positive aspects of the FMFIA are that first, the Navy has taken action to establish internal control evaluation procedures. Within the last two years, the DON has established and clarified a number of written procedures to guide activities in implementing a satisfactory internal control program.

Second, the Navy has identified and corrected material weaknesses. Some of these weaknesses, however, are long-standing problems which take time to fully correct, and the solutions are not always easy.

Third, as a result of the FMFIA, the Navy has also identified and corrected a number of weaknesses, which individually are not considered to be material in lost money, time, etc. However, these weaknesses usually involved failure to comply with established policies and procedures, and collectively are important since failure to correct these weaknesses could have a material effect if all items are considered.

D. RESEARCH METHODS

The information gathering for this thesis included review of the published GAO audits and other studies, plus DOD and DON instructions relevant to the internal control

program. In addition and more importantly, a telephone survey was conducted which asked the interviewees what kind of implementation problems they had experienced with regard to implementing the requirements of the FMFIA and internal control program at their organizational level.

The interviewees consisted of personnel from the Office of the Navy Comptroller, the Navy Accounting and Finance Center, the Chief of Naval Operations, the Commander in Chief, U.S. Atlantic Fleet, the Commander Naval Surface Force, U.S. Atlantic Fleet, the Chief of Naval Education and Training and the Naval Audit Service.

These commands were selected because each of them has a direct impact on the implementation process and most have subordinate commands to whom they provide internal control guidance.

The telephone interviews were conducted with twelve individuals who had some responsibility for the internal control program at these activities. The procedure used during the interviews was to explore the history of the implementation process at their commands and then ask what specific implementation problems they had experienced with the program. Each implementation problem identified during the interviews was then further investigated to determine whether or not this problem appeared to be a Navy-wide problem. The interviewees were also asked what solutions to

their implementation problems they had arrived at and what improvements they would recommend.

E. DON INTERNAL CONTROL PROGRAM IMPLEMENTATION PROBLEMS

The internal management control review process previously described would seem to be a relatively simple process that, if followed carefully, would produce adequate results and satisfy the requirements of OMB Circular A-123 and the FMFIA. Nevertheless, the Navy has experienced numerous implementation problems which have been the source of tremendous frustration for Navy managers. The first list of identified implementation problems are derived from published GAO reports (ref. 7) and a study completed by the President's Council on Management Improvement (ref. 8) and include:

1. Paperwork and workload burden
2. Inadequate basis for reporting
3. No follow-up or tracking system for reporting corrected internal control deficiencies
4. Accounting systems did not conform to GAO requirements

Each of these areas will be examined more closely.

1. Paperwork and workload burden

The President's Council on Management Improvement highlighted the paperwork and workload burden of the program in their October 1985 report (ref. 8:p.1). Two of the major findings from this report were that : 1) a substantial time and paper burden was created in the FMFIA's implementation;

and 2) similar vulnerability assessment results could have been accomplished through a simpler process with less paper.

In GAO's December 1985 audit of the FMFIA (ref.9:p.54) GAO wrote that a common concern surrounding the Act has centered on documentation of systems and the view that the evaluation process has become a burdensome paper exercise. Additionally, the House Committee on Government Operations expressed concern that some agency officials believed that implementation of the Act had accomplished little beyond adding to the paperwork burden. The Committee concluded that if managers adopt the view that the implementation process is merely a burdensome paper exercise, this attitude will hamper efforts to achieve substantial improvement in the management of the Federal Government.

The President's Council on Management Improvement report found that the vulnerability assessment process was the most frequently criticized process. They found that managers believed that this process was required to be performed too frequently. In addition, some managers thought the vulnerability assessment process could be done by relying on information produced from existing management control evaluation and reporting processes.

Another major problem is staffing. Although the individual managers were responsible for reviewing their programs, there were no personnel billets identified to

coordinate the command programs or train the managers on the proper procedures. The Internal Control Program coordinators were generally found in the internal review organization or given to a junior officer as a collateral duty, and usually the program coordinators had no knowledge or experience in the area of internal control systems.

2. Inadequate basis for reporting

One problem the Navy has encountered during implementation is an inadequate basis for reporting their internal control systems as being in compliance with prescribed standards. The Navy did not know how general prescribed standards would apply to their operations and their systems that were under development. The GAO audit (ref. 9:p.35) reported that agencies did not know if controls were adequate because their internal control programs had not yet evolved to the point that they provided an adequate basis to determine that the Navy's systems of internal controls, taken as a whole, met the requirements of the Act. In addition, there had been difficulty in identifying systemic internal control problems.

3. No follow-up or tracking system for reporting corrected internal control deficiencies

Another problem area noted by the GAO was that most Navy activities had not established required formal tracking and follow-up systems to monitor and ensure that internal control deficiencies were promptly corrected. GAO stated

that the Navy could progress significantly in its future FMFIA effort by implementing the required tracking and follow-up systems throughout the Navy (ref. 7:p.22). Two major reasons given for the lack of a system were no guidance on exactly how to set up a system and the reporting requirements under the system. Given the quality of the initial implementation guidance, these reasons appear valid.

4. Accounting systems did not conform to GAO requirements

As stated earlier, only one of the fourteen Navy accounting systems is in compliance with DOD Accounting Manual procedures. The GAO audit on the Navy's implementation progress (ref. 7:p.6) stated that the Navy did not evaluate and test in operation any of their accounting systems, did not adequately coordinate internal control reviews with accounting system evaluations, and had not established an adequate system to track accounting system deficiencies.

F. RESULTS OF INTERVIEWS

The specific implementation problems listed below are derived from the results of the interviews with the commands listed above, and represent the interpretations or perceptions of the interviewees on the effect of the implementation problems on the overall effectiveness of the internal control process. The major implementation problems identified in the interviews include:

1. Decentralization of the Navy
2. Manager's resistance to participate
3. Lack of procedural guidance
4. Definition of an assessable unit
5. No standard inventory of assessable units
6. Vulnerability assessments less than required
7. Lack of manager training
8. Paperwork burden

Each of these areas will now be examined.

1. Decentralization of the Navy

The Federal Managers' Financial Integrity Act process is, in general, a very cumbersome process. This is particularly a major problem for large decentralized organizations such as the Navy. The paperwork aspects of the program are compounded by the need to promulgate the program down through the Navy chain of command to the lowest managerial level. The lowest managerial level is then required to complete the required management control reviews in a short time frame to satisfy the reporting requirements up the chain of command. This layering effect can sometimes involve five or more levels, which can slow the overall process and make the manager on the bottom of the chain of command sometimes perform his work in a crisis mode.

2. Manager's resistance to participate

With the introduction of any new system to an organization there will always be some internal resistance

to change that is normal human reaction. The Navy was no exception when it tried to implement their internal control program. Each interview conducted referred to the problem of manager resistance to participate in the program. There were several reasons given for this problem. First and foremost, the managers believed that by reporting and documenting their internal control weaknesses, they were in effect putting themselves "on report". Managers thought that the program was making them into auditors. Secondly, managers believed the enormous time and effort imposed in completing the process was not well spent and could be used on more productive work. Thirdly, most line managers viewed this as a "staff" problem and, therefore, felt that they did not need to participate because they believed that internal controls only applied to accounting and financial controls and not administrative controls. Finally, if the command's internal control program coordinator was successful in getting the organization's managers to participate, the sketchy or nonexistent guidance and training from the headquarters level caused a lot of managers to call the program a failure before it had a chance to be implemented.

3. Lack of procedural guidance

A major problem for the Navy was that procedural guidance on implementing certain areas of the FMFIA was inconsistent and overlapping. Some interviewees believed that the entire process on how the Navy wanted to implement

the program was not completely thought out prior to issuance of the first SECNAV instruction. In addition, the Navy had not completely resolved who was going to be involved in the reporting cycle, how to perform vulnerability assessments and internal management control reviews, and realistic training programs for managers were not ready. This led to major confusion among all Navy commands because no one really understood the entire process. Initial guidance was simply a distribution of the OMB guidelines and GAO standards.

4. Definition of an assessable unit

The major problem addressed in the interviews was that there was not a consistent definition of what an assessable unit was and how detailed the assessable unit had to be. This problem ties back into the problem of poor guidance. Some activities segmented their organizations into assessable units based on their organization charts (e.g., Supply, Operations, Administration, etc.) while some segmented these into smaller units (e.g., Supply was segmented into purchasing, receiving, shipping and disbursing).

5. No standard inventory of assessable units

This is a follow-on problem from the above discussion. The point here is that because the Navy had no standard inventory of assessable units, it had a problem directing which areas Navy commands should review on a

systemic basis, because some commands had not segmented their commands in the same way as other commands.

6. Vulnerability assessments less than required

The GAO audit noted that agencies have devoted considerable resources to making vulnerability assessments, and the vulnerability of thousands of operations have been assessed. Nevertheless, these efforts have not resulted in reliable and useful information to managers.

In the interview with the Naval Audit Service (ref.10), the problem of lack of good vulnerability assessments at the commands that the Naval Audit Service had reviewed was discussed. A major problem in this area was that managers had a preconceived judgment over what the vulnerability of a program should be. This judgment was used instead of the process discussed earlier to identify the controls already in place that could reduce the vulnerability of that area. As discussed before, vulnerability assessments are to be a preliminary analysis by the manager on where internal control strengths and weaknesses may exist in their programs and on the susceptibility of their programs to fraud, waste or abuse.

7. Lack of manager training

All interviewees agreed on this point. If the entire internal control process is to work and the requirements of the FMFIA are to be met, then it is vital that all managers receive training in the internal control process.

Unfortunately, there was a poor definition of what training was required and, therefore, the quality of training was unsatisfactory. Instructing and training managers must be performed to provide them with a better understanding of what was required of them. The consensus of opinion was that if all the managers were trained in the process, then the reviews and reports produced would be of higher quality and the Navy would have a better basis for reporting.

8. Paperwork burden

Most interviewees had some comment on the paperwork burden of the program as it related to manager resistance to the program. The problem pointed out in the interviews was that their managers had a firm belief that the entire internal management control process was requiring them to spend already scarce resources documenting a lot of information that they did not feel was particularly useful to them. Most managers felt that documenting their systems should produce information that could assist them in developing corrective actions and planning future work. The interviewees noted that this type of comment from managers was common and generally came from frustrated managers who had resisted the program from the outset.

G. CONCLUSION

The Navy is well aware of all of the problems mentioned above. Most of the problems identified during the

interviews and studies result from the fact that the Navy's internal control program has not yet fully evolved into an effective program.

Some of the major findings included in this chapter were the manager's resistance to participate in the program, the paperwork and workload burden, lack of good procedural guidance, and no follow-up system for internal control deficiencies. The Navy recognizes that several improvements are still required to achieve a quality internal control program.

The next chapter will describe some of the Navy's solutions to the identified implementation problems.

V. NAVY'S SOLUTIONS TO IMPLEMENTATION PROBLEMS

A. INTRODUCTION

The GAO audits of the Navy's implementation of the FMFIA have commented on the Navy's implementation progress. The GAO noted that the "Navy had made progress in developing and implementing its internal control evaluation program and in reviewing its accounting systems for conformance with the Comptroller General's requirements" (ref. 7:p.2). In addition, "the Navy increased its organizational and functional coverage; conducted more assessments of the risks of fraud, waste, and abuse; completed an inventory of its accounting systems; and evaluated two major accounting systems and two subsystems" (ref. 7:p.2).

The following are areas in which the Navy has made progress in correcting implementation problems. The solutions described below have been gathered from the interviews with major Navy commands.

1. Updating internal control program guidance
2. Using other sources of information to substitute for Internal Control Reviews
3. Integrating audit plans into the Management Control review process
4. Improving manager training
5. Writing an Internal Control Review plan based on vulnerability assessments
6. Internal Control Information System

A detailed description of each of these areas is presented below.

B. NAVY'S ACTIONS TO SOLVE IMPLEMENTATION PROBLEMS

1. Improving Internal Control Guidance

NAVCOMPT and CNO recognized that several improvements were needed to achieve a quality program and emphasized consistent, good quality management control reviews, particularly documenting the control process and testing control techniques.

NAVCOMPT and CNO established and clarified a number of written procedures to guide commands and activities in implementing a satisfactory internal control program. Some of these changes include revising the vulnerability assessment process from a 2 to a 5 year cycle and providing more direction on specific areas to review.

2. Using Other Sources of Information to Substitute for Internal Control Reviews

A substantial portion of management's resistance to the program came from managers who believed that the management control review process was duplicating the efforts of inspection and audit teams. The internal control program process required that the manager review his areas of responsibility to identify weaknesses and document the entire process. At the same time, the same manager was being audited or inspected in the identical area. Most

managers felt that this was a tremendous duplication of effort and laid the blame on the management control process.

Recognizing the problem, the new OPNAVINST allows Navy activities to use other management control activities such as management studies, audit reports, inspections and reviews to assess controls and substitute these for internal management control reviews. This solution was implemented because most agencies believe that audit reports, management studies and command inspections are an integral part of an effective management control system.

3. Integrating audit plans into the management control review process

The Naval Audit Service has a number of functional area audit plans that are used by auditors when auditing Naval activities. These functional area audit plans serve as general guidelines for the auditors to check for compliance with directives and procedures. The audit plans do not include every possible area that can be reviewed in the functional area, but are the minimum effort required by the auditor. The reason for this is because the Audit Service wants their auditors to have some degree of flexibility when reviewing a particular area to investigate additional areas.

The Navy is attempting to integrate these audit plans into the management control review process. This will allow activity managers to use these audit plans to aid them in performing their internal management control reviews.

The Navy hopes that each activity will use these audit plans as a baseline to possibly develop checklists of their own that can be tailored to specific management control problem areas. However, there are pros and cons to using this approach. Checklists are a management tool that can be used effectively, but they can also be misused. Checklists can be effective in ensuring that important review areas are not forgotten. They can serve as a reminder to managers that they need to ensure adequate review is given in each particular area. However, usually checklists are not all inclusive. Managers have a tendency to review only those areas that are included on the checklist, thereby potentially missing areas that need closer management review. What the checklist does provide is a point of reference; but the checklist does have the potential for misuse if the manager relies solely on the checklist to complete his management control reviews.

4. Improving Manager Training

Lack of or no training for the manager was a serious problem the Navy needed to solve if the program was to be successful. Two areas were developed by the Navy as solutions to the problem. DOD disseminated a self-instructional course on conducting internal control reviews. The Navy believes that when this course is combined with better headquarters guidance and quality assurance techniques at the local level, it will achieve the desired

improvements because proper training will afford managers the knowledge required to perform the required tasks within the program and hopefully achieve better results. Some interviewees, however, found the self-instructional course to be too general to be of any use.

Probably one of the best improvements to the program is the internal control program indoctrination that prospective Commanding Officers (PCO) and prospective Executive Officers (PXO) receive. The goal is to indoctrinate as many PCOs and PXOs as possible on the internal control program prior to reporting to their new assignments. By making these officers aware of the internal control program and the importance of establishing and maintaining an effective internal control program, it is hoped that internal controls can become a mindset among line managers. Most interviewees believed that this improvement of increasing the consciousness of Navy managers to internal controls will go much further in the Navy's effective implementation of the program, because if Commanding Officers and Executive Officers take an active interest in the program, it can be successful.

5. Writing an Internal Control Review Plan Based on Vulnerability Assessments

One problem area previously mentioned was that the internal control reviews were sometimes duplicating the efforts of recently completed audits, inspections and other

reviews. To solve this duplication of effort problem, the CNO, in conjunction with the Naval Audit Service, is writing a five year internal control review plan based on the results of the Navy's vulnerability assessments. This five year plan will be meshed with the Naval Audit Service's five year audit plan to determine which areas will be reviewed by the Naval Audit Service, and will satisfy the requirement of completing a management control review. The resulting audit plan and internal control review plan will be reviewed by the AVCNO and the Naval Audit Service, and will be prioritized based upon the results of the Navy's vulnerability assessments. Joint approval of these plans will be accomplished by both activities. This is a change that is allowed under the recent revision to OMB Circular A-123. By merging the internal control plan and audit plan, the Navy hopes there will be a reduction in the duplication of effort. In addition, if this meshing is successful, the Navy believes that the program implementation will be improved due to increased functional area coverage, a greater number of assessments can be conducted and, best of all, there will be improved identification and correction of internal control weaknesses.

6. Internal Control Information System

The Navy has developed an innovative alternative to the traditional approach to accounting systems evaluations. The traditional approach is weak in a number of significant

areas. First, the traditional approach has often failed to encompass the entire system looking only at individual segments of systems. Second, qualitative measurements of specific threats facing a system and the resulting risk reductions achieved by individual internal controls have not been obtained. Lastly, the traditional approach has not allowed for cost-benefit analysis of the merit of specific internal controls.

As a specific action to overcome these shortcomings, NAVCOMPT has developed the Internal Control Information System (ICIS) (ref. 11). The ICIS is a subset of NAVCOMPT's Consolidated Systems Evaluation Program (CSE). CSE is a comprehensive approach to accounting systems reviews to determine the adequacy of an accounting system's conformance to regulations, data processing soundness, functional soundness, and internal control soundness.

ICIS is a computer/software supported approach to internal control review and improvement which addresses each of the shortcomings of the traditional approach to accounting systems evaluations. The ICIS reviews entire systems instead of individual segments and develops and addresses specific threats, associated dollar risks, and risk reduction achieved by individual controls.

ICIS is not a checklist approach to internal control evaluation. It is an approach which evaluates the threat and potential dollar impact in each area. Expected threat

occurrence rates are determined and all controls and their risk reduction are computed. This procedure produces a listing which shows initial exposure, risk reduction achieved by specific controls and the remaining risk after all controls are considered. This allows the manager to look at each control with regard to its cost-benefit. In addition, the ICIS allows managers to use sensitivity analysis to explore the impact of adding, deleting or modifying internal controls.

Finally, the ICIS appears to be an efficient, innovative approach to accounting systems reviews. It is certainly a step in the right direction, and it is hoped that this system will prove to be effective in improving reviews of internal controls in the Navy's accounting systems.

C. OTHER IMPROVEMENTS

Two other improvements deserve mention here. The President's Council on Management Improvement's report identified the following two areas of potential improvement to the implementation process. The Council looked across different government agencies to see what they were doing in relation to accomplishing the requirements of the FMFIA. The Navy is working on the following two areas.

1. Developing a Short Form for Management Control Reviews

The Department of the Army has developed a checklist approach to the internal management control review. The Army

moved in this direction because of the extensive amount of Army regulations (not unlike the Navy) that specify how functions should be performed so more standardization was needed. This was accomplished by adjusting responsibility for internal controls around functional managers and by moving to a standard checklist.

The checklists include identification of the task under review, the associated risk, control objectives, and control techniques. The checklists are designed to aid the operating managers in determining if internal controls are operating properly within their area of responsibility. Operating managers use the checklists to test internal controls and provide feedback and suggestions to functional managers.

One interviewee stated that the Navy has done some preliminary work in this area, but development of the Navy checklists has been slow because of the nature of the Navy's internal control reviews are so diverse. Designing a concise checklist has been difficult. Some commands were trying to develop local checklists tailored to their specific commands. Further investigation by the Navy into developing management control review checklists appears warranted, since it can be shown that when correctly used these checklists can reduce the paperwork burden previously discussed.

2. Using a New Vulnerability Assessment Form

Another area noted by the President's Council was a vulnerability assessment short form adopted by the Federal Highway Administration. The Navy has modified this form for use within the DON. This form provides the manager with a concise one page checklist designed to provide a review of the general control environment, analysis of inherent risk and a preliminary assessment of safeguards. Some interviewees believe that the implementation of this new form will be very useful to managers because it will allow managers to reduce the time and paperwork required to perform vulnerability assessments.

D. SHORTCOMINGS OF THE NAVY'S ACTIONS

The Navy has made some progress in implementing the FMFIA. The Navy's efforts to develop and improve its internal control evaluation program, albeit slow, have proven to be relatively successful. Nevertheless, there are still some shortcomings in the Navy's program.

First, the Navy has spent an inordinate amount of time identifying and documenting internal control weaknesses and, in most cases, planning and taking corrective actions. However, the Navy has not routinely tested the corrective actions of the internal controls to verify that these corrective actions are being systematically implemented and the controls are now operating as intended. The Navy needs

to ensure routine testing of corrective actions to determine their effectiveness.

Another shortcoming of the implementation process is that internal control awareness in the Navy has not completely filtered down to all applicable management levels. The impression received throughout the interviews was that many of the subordinate commands had not fully implemented their own internal control programs. To completely implement a totally effective internal control program, the Navy must ensure that internal control systems are implemented at all Naval activities to provide the means for preventing fraud, waste, and abuse. The best way to achieve this objective is to make internal controls a mindset among Navy managers. This requires that the internal control program evolve to be part of the management organization of the Navy.

The Navy needs to find a way to give the line managers more incentive to implement and maintain effective internal control systems. The line manager must be convinced that effective internal control systems are of greater benefit to him than weak controls. The benefits must be explained to him in terms that he can understand. For example, if the line manager can be shown that lack of a specific control is draining his resources and requiring him to forego meeting mission requirements (such as less ship underway time or flight hours, or not enough warfare training

exercises to enable his crew to become more battle proficient), then effective internal control systems can potentially be implemented and line managers will begin to associate good internal control systems with increased readiness. This effort will continue to be a major challenge for top Navy management, because getting this type of incentive across to all Navy managers is difficult due to the decentralized nature of the Navy's organization.

Another shortcoming noted is that the Navy needs to concentrate on the results of the program. Strengthening internal controls and accounting systems is the bottom line of the FMFlA. The Navy needs to concentrate more on the substance of the evaluation process and less on documentation and report language to achieve the overall objective of improving internal controls and accounting systems.

Finally, the Navy's organization needs to investigate how it can ensure the overall effectiveness of its internal control program. In the private sector the approach used is the formal audit committee. This committee oversees the various audits to ensure the overall effectiveness of the audits the particular company receives. The members are independent of management. This is important because it relieves management of any pressure, perceived or otherwise, which may impact on the effectiveness of the particular audit. The Navy may investigate use of an inter-disciplinary

body apart from NAVCOMPT and AVCNO to integrate the various internal control concepts and definitions and to develop a common reference point. This body's guidance would move to develop a standard against which other activities can judge the effectiveness of their internal control programs, and thus help other Naval activities improve their internal control systems. This oversight committee could be charged with overseeing the financial reporting process and the Navy's internal control system. It could also independently ensure that the Navy was making satisfactory progress toward improving systemic internal control weaknesses and further enhance the Navy's ability to report their accounting systems and internal controls in compliance with the FMFIA.

E. CONCLUSION

The Navy is working to strengthen its internal management control program. While progress has been made by the Navy to correct some of the implementation deficiencies and smooth out the rough edges, there is still a lot of work that the Navy needs to do before it has an effective internal management control program and more importantly a system of internal controls that will meet the intent and the requirements of the FMFIA.

The last chapter provides a summary along with some recommendations and conclusions on what additional actions the Navy could possibly undertake to make further progress in the implementation of the Act.

VI. CONCLUSIONS AND RECOMMENDATIONS

A. SUMMARY

The purpose of this thesis was to determine whether the Navy has successfully implemented the Federal Managers' Financial Integrity Act of 1982; to determine if the Navy has resolved their implementation problems, and if the Navy has come up with any innovative ideas to make the management control process more efficient and effective.

This thesis consolidates and highlights information on the Navy's implementation problems and their efforts to improve their internal control problems. After the initial historical background of internal control program development in the Federal Government, an explanation of the current internal control evaluation system was covered. This chapter was presented to give the reader an appreciation of the depth of information and workload required by the current internal control process.

The history of the Navy's Internal Control Program, the Navy's financial management structure and accounting systems weaknesses, and the implementation problems the Navy has experienced in implementing their internal control program was then developed and discussed. The information in this chapter was designed to show the reader the historical difficulties encountered by the Navy in organizing their

program, the type of organizational structure the Navy operates under and present the implementation problems encountered by the Navy in detail.

The Navy's solutions to the implementation problems and the shortcomings of those solutions were then covered in detail. The reader should hopefully obtain from this chapter an appreciation of the Navy's efforts in correcting their implementation problems. Additionally, it should be apparent to the reader how much further the Navy's program needs to evolve before it can be judged as being completely entrenched in the Navy's organization.

The generalization of the results of this study are limited, given that only a few activities were able to be interviewed. Nevertheless, since the activities interviewed were senior Navy echelon commands, the results of this study could be extended to other Naval activities.

B. CONCLUSIONS

Based on the research conducted for this thesis, one conclusion reached was that the concept of internal control in the Navy has progressed significantly over time since the program's inception. It has grown from merely a means to detect and prevent fraud to include the means of effectively performing a mission or realizing an objective.

The FMFIA process has produced a heightened awareness of the importance of internal controls at all management levels

and has reiterated management's responsibility for establishing and testing those controls.

The Navy's efforts to fully implement the FMFIA are far from complete. Although the basic framework for an effective internal control program has been established within the Navy, the research conducted indicates further implementation must be done before the Navy's program can provide an adequate basis for determining that internal controls, taken as a whole, comply with the objectives of the Act. The Navy has recognized the deficiencies in the implementation process and has moved to correct these system deficiencies.

In my opinion, the largest obstacle the Navy needs to overcome to make implementation of internal controls successful is the line manager's resistance to participate in the program. This problem is compounded by the decentralized nature of the Navy's organization. As stated before, the Navy's internal control program needs to evolve to be part of the management organization. How is the Navy to achieve this evolution? My opinion is that the Navy needs to go back to basics and have managers assess themselves by looking at what they are assigned to do, evaluate the results against whether or not they are doing it, and if there is a difference between the two, then take the appropriate corrective actions. Giving the line manager

more incentive to have strong internal control systems is also extremely important.

Unfortunately, this simplistic solution will only work where the Navy already has good managers in place. Implementation of effective internal control programs has not been a major problem where good managers existed. Where poor managers exist, internal control programs will tend not to be successful. If this is the case then increased scrutiny over these poor managers will be required to ensure the objectives of the internal control program are achieved.

Other implementation problems and solutions are procedural in nature and the solutions will eventually make the Navy's internal control program more effective.

C. RECOMMENDATIONS

What will be the future of the Navy's internal control program? Although a number of Navy managers probably thought that this was just another bureaucratic program that would die away, my view is that the Navy's internal control program with the backing of the FMFIA is here to stay. The future of a successful program, however, will depend on a number of factors that have been previously discussed. Since the program is not going away, it is in the best interest of the Navy to make the program work for the Navy and improve its internal controls and accounting systems instead of making the Navy work for the program.

The following actions are recommended:

1. The Navy needs to continue to incorporate the internal management control process into the overall management process. This would result in greater support for the internal control process and would relieve duplication of reviews and tracking systems.
2. The Navy should consider reducing the paperwork burden, and reduce staff days required to maintain the process by further developing checklists to help managers perform internal control reviews. These checklists should include the minimum essential controls needed to comply with the internal control standards. These checklists would serve to reduce the program down to a simple, manageable level.
3. The Navy needs to continue to gain the support of senior line managers in relation to the internal control process through incentives in terms the line manager can relate to. This is a critical area because without these senior manager's support the internal control process will not succeed. The Navy's efforts in indoctrinating PCOs and PXOs will make this much easier.
4. The Navy needs to continue its efforts to implement an effective tracking and follow-up system. Such systems are essential to monitor and ensure that actions developed to correct internal control deficiencies are

completed. The Navy needs to establish a central area such as the AVCNO for reporting correction status of weaknesses and streamline follow-up for all identified weaknesses.

5. As a related recommendation, the Navy could establish an improved implementation feedback program. This, along with a system of lessons learned, could ensure that implementation problems are identified for evaluation and serve as a guide for managers to determine the actual status of their implementation process.
6. To fully implement an effective internal control program, the Navy needs to develop more effective manager training which supports the program and gives a set of guidelines for the establishment and reviews of internal controls.
7. The Navy needs to continue to focus on alternative ways to complete the management control review process which are most cost-beneficial. The Navy has moved closer in this direction by now allowing the use of audits, inspections and other reviews to serve the purpose of management control reviews.
8. As a long range goal, the Navy should study the feasibility of establishing a computer network for reporting requirements of the Act. Automating the documentation of vulnerability assessments and

management control reviews could go a long way toward implementing recommendations 4 and 5.

9. The Navy needs to investigate the use of an oversight committee, possibly including outsiders, to integrate internal control concepts and definitions and to develop a common reference point. This body could help ensure the Navy was making satisfactory progress toward improving internal control weaknesses and enhance the Navy's ability to meet the requirements of the FMFIA.

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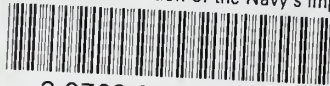
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